



**ENTERED**

TAWANA C. MARSHALL, CLERK  
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**The following constitutes the order of the Court.**

**Signed June 9, 2006**

  
**United States Bankruptcy Judge**

IN THE UNITED STATES BANKRUPTCY COURT  
FOR THE NORTHERN DISTRICT OF TEXAS  
ABILENE DIVISION

IN RE:

JAMES ALBERT JAY,

DEBTOR

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CASE NO. 01-11000-RLJ-13

JAMES ALBERT JAY AND ANN C. JAY,

Plaintiffs

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§

VS.

ADVERSARY NO. 02-1009

NESCO ACCEPTANCE CORPORATION,  
NESCO, INC., BANK ONE, OKLAHOMA,  
N.A., AND LINC ACQUISITION ONE,  
L.L.C.

Defendants

§  
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**MEMORANDUM OPINION**

On March 28, 2006, the Court held a hearing to consider two issues in light of the reversal

and remand of this adversary case by the Fifth Circuit Court of Appeals. The plaintiffs, James Albert Jay and Ann C. Jay, contend that the Fifth Circuit's reversal requires a reconsideration of this Court's prior holdings concerning (1) the amount of Nesco's<sup>1</sup> claim against the Jays; and (2) the non-payment by Nesco of the approximate \$240,000 "equity" in the property transferred. Nesco contends that reconsideration of these two issues is unnecessary as the Court's findings concerning Nesco's claim were not appealed by either party. Both Nesco and the Jays agree that these issues are relevant only as they concern Nesco's claim against Ann Jay, wife of the debtor James Albert Jay, as any claim against Mr. Jay was discharged on October 22, 2004, by the discharge granted to him in his chapter 7 bankruptcy case.

### **Background**

The claims raised by this adversary proceeding were, at the parties' request, bifurcated for trial. The court first held a hearing on July 23, 2003, and heard evidence on the claims by the Jays, as plaintiffs, seeking cancellation of the deed purportedly conveying a .85-acre tract of land (with improvements consisting of a convenience store and gas station), which they claimed as their business homestead, to defendant Nesco. The Jays argued that the transaction was a pretended sale of their business homestead in violation of the Texas Constitution. The Court issued its memorandum opinion on September 30, 2003 (the "September 30, 2003 Memorandum Opinion"), holding that the transaction was a pretended sale of a business homestead and, under principles of equity, converted the deed to an improper mortgage lien against the Jays' business homestead. The Court held that Nesco therefore held an unsecured claim, evidence on which was

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<sup>1</sup>The Court will simply refer to "Nesco" when referring to position and interests of Nesco Acceptance Corporation, Nesco, Inc., and Linc Acquisition, L.L.C. ("Linc"). By transfer filed with the Court, Nesco assigned its rights of recovery to Linc.

to be submitted at the second phase of the bifurcated trial.

The second hearing of the bifurcated trial, which addressed all other issues raised by the adversary, was held December 8 and 9, 2003, with the parties submitting post-trial briefs on December 19, 2003. The issues raised by the second trial concerned the following: the amount of Nesco's claim; the Jays' claims of fraudulent inducement, fraudulent misrepresentation, negligent misrepresentation, and breach of contract; and the claim of defendant Linc, a lienholder against the .85-acre tract, that it was a bonafide lienholder against the property. In response to the Jays' damage claims, Nesco contended that such claims must fail because of (i) Nesco's affirmative claims of past-due rent, an implied vendor's lien, restitution, quantum meruit, cancellation of the lis pendens filed by the Jays; and (ii) its defenses, including estoppel, contributory negligence, and failure to mitigate. By its memorandum opinion issued March 10, 2004 (the "March 10, 2004 Memorandum Opinion"), in connection with the second phase of the bifurcated trial, the Court denied Linc's innocent lienholder claim and the Jays' claims for damages, and found that Nesco was entitled to an unsecured claim equal to the principal loan amount of \$1,281,000, less credited lease payments and the value of a 1.4-acre tract (\$176,000), plus interest to the time of the Jays' bankruptcy filing. Nesco was instructed to file a proof of claim (or amended claim) within twenty days of entry of the Court's order entered in connection with the March 10, 2004 Memorandum Opinion. On April 2, 2004, a final judgment was issued by the Court on all issues tried to the Court in connection with the bifurcated trial and subject of the two memorandum opinions.

Upon appeal to the district court, the district court affirmed this Court's ruling. Upon further appeal, this time to the Fifth Circuit, the Fifth Circuit reversed and remanded for

proceedings not inconsistent with the Fifth Circuit's opinion.

The Fifth Circuit considered three issues on appeal: (1) whether the district court (and thus this Court) erred in applying the business homestead requirements provided in the Texas Constitution prior to the 1999 amendments; (2) whether the district court and this Court erred in concluding the parties' transaction was, in effect, a "pretended sale" prohibited by the Texas Constitution; and (3) whether the district court and this Court erred in concluding that Linc was not an innocent lienholder. 432 F.3d 323 (5th Cir. 2005). The Fifth Circuit reversed on the first issue. The Fifth Circuit specifically held that it was improper to "relate back" the execution of the warranty deed in January of 2000 to the signing of the lease agreement in December, 1999. *Id.* at 326. The Fifth Circuit did not disturb this Court's findings of fact.<sup>2</sup> Given no relation back, the amended constitutional provision applied thereby defeating the Jays' homestead claim.<sup>3</sup> The Fifth Circuit pointed out that it was unnecessary to address Nesco's other arguments "as they are premised on a determination that the .85 acre tract was a homestead under the Texas Constitution." *Id.* at 327.

### **Discussion**

#### **(1) Nesco's Claim**

The homestead finding was the underpinning for all issues on appeal. The reversal of this Court's homestead finding unravels the following conclusions by the Court, none of which would have been addressed absent its homestead finding: that the transaction between the Jays and

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<sup>2</sup>The Court hereby makes reference to this Court's statement of facts which are set forth in the Court's September 30, 2003 and March 10, 2004 Memorandum Opinions.

<sup>3</sup>As discussed at length in the Court's September 30, 2003 Memorandum Opinion, the amendments to the Texas Constitution in November, 1999 require that a homestead claimant actually reside at his business homestead, i.e. it must be part of the residential homestead.

Nesco was a pretended sale; that the January, 2000 deed was void ab initio; that title never passed to Nesco; that equity converts the transaction to a loan secured by a mortgage; that the mortgage is void as an improper lien taken against the homestead; that Nesco's claim is based on funds *advanced*; and that Linc was not an innocent lienholder.<sup>4</sup> In short, the nature of the transaction is no longer called into question. The transaction is as it appears on the surface: a sale and leaseback. The Court cannot treat it any other way. The propriety of the transaction was not otherwise questioned by the Jays. Given this, it is necessary to revisit Nesco's claim. This Court held that Nesco had a claim of \$1,281,000, less credited "lease payments" and the value of the 1.04-acre tract (\$176,000). After netting out these credits, the resulting judgment for Nesco was held to be \$1,005,000, plus prejudgment interest. The total claim of \$1,281,000 reflected the "principal amount" of the loan as set forth on the schedule of payments attached to the lease agreement between the parties.

The Court now measures Nesco's damages, and thus its claim, as arising exclusively under the lease. Nesco is the landlord; the Jays are the defaulting tenants. This approach is acknowledged by both Nesco and the Jays in their briefs.<sup>5</sup> Nesco argues that it may treat the Jays' default as an anticipatory repudiation of the lease thereby allowing it to repossess the premises and sue for the present value of the future rentals. Under this approach, Nesco asserts that its claim is measured by the total of all missed rental payments under the lease (both accrued and

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<sup>4</sup>The Court did make other findings and conclusions that were not dependent upon or related to the homestead claim. The Court found that no evidence was presented that raised an issue regarding the Jays' asserted causes of action for fraudulent inducement, fraudulent misrepresentation, or negligent misrepresentation. In addition, upon consideration of the evidence presented, the Court denied any relief on the Jays' breach of contract claim.

<sup>5</sup>Nesco and the Jays submitted letter briefs to the Court dated March 17, 2006 and March 18, 2006, respectively.

future rentals), reduced to present value, which yields a total claim for rents of \$1,333,299.24. Against this sum is credited the fair market value of the property. In this regard, the parties have advised the Court that upon the Fifth Circuit's ruling they mutually agreed to a sale of the property (the .85-acre tract with convenience store and gas station), which took place on February 10, 2006, and resulted in a net payment to Linc of \$506,825.04. Crediting this amount against the past-due and future rentals yields a total claim, according to Nesco, of \$826,474.20. As an alternative, Nesco submits that it may elect to assert a claim for "rent as it comes due until the property is re-leased and then sue for rent lost in the interim. The measure of damages under this . . . theory of recovery would be the payment due under the contract from April 1, 2001, to February 10, 2006, the day the property was sold." Nesco submits that under this method no credit is allowed upon sale of the property. Nesco's damage model reflects that the total unpaid rentals from April 1, 2001, through December 31, 2005, is \$656,777.37. Nesco's model assumes lease payments due of \$12,001.40 per month for January and February of 2006. Its claim, therefore, for past-due rentals would be \$680,780.17.

The Jays do not attempt to liquidate Nesco's claim. They simply argue that "[t]he only arguable basis for granting [Nesco] a claim . . . is to compensate for rent due." Of the two approaches, Nesco obviously elects the anticipatory breach option as it results in the greater claim. The claim is greater because this approach includes future rentals and the credit for the sale of the property falls well short of covering the future rentals. The Court agrees, as a general rule, that a landlord may have various options in choosing the remedies available to it upon a tenant's default. *See Crabtree v. Southmark Commercial Mgmt.*, 704 S.W.2d 478, 480 (Tex. App.—Houston [14th Dist.] 1986, writ refused n.r.e.). The question here is whether Nesco

should, under the circumstances, have the option to recover for the future rentals, i.e. the rents that were to come due after the February 10, 2006 sale of the property. This raises the underlying question of whether the lease has been terminated. This inquiry is controlled by Texas law. *See In re SKA! Design, Inc.*, 308 B.R. 777 (Bankr. N.D. Tex. 2004) (whether a lease had been terminated by a tenant's surrender of the leasehold property is a question of state law).

A lease may be terminated by mutual agreement, breach of the agreement by the lessor, or surrender by the lessee with acceptance by the lessor. 49 Tex. Jur. 3d Landlord and Tenant §§ 311-324 (2005). "A surrender of a tenancy is a yielding up of the tenancy to the landlord so that the tenancy and the rights or interests of the parties thereunder are extinguished by mutual agreement." *Id.* at § 321 (citing *Arrington v. Loveless*, 486 S.W.2d 604 (Tex. Civ. App.—Fort Worth 1972, no writ)); *Patteson v. McGee*, 350 S.W.2d 241 (Tex. Civ. App.—Eastland 1961, no writ); *see also Four Bros. Boat Works, Inc. v. S & SF, Inc.*, 55 S.W.3d 12, 16 (Tex. App.—Houston [1st Dist.] 2001, no pet.). A surrender by operation of law may result by the tenant's abandonment of the leasehold and the landlord's re-entry. *See Ingleside Prop., Inc. v. Redfish Bay Terminal*, 791 S.W.2d 217, 219 (Tex. App.—Corpus Christi 1990, no writ) (if tenant wrongfully abandons leased premises and defaults in rental obligations, landlord re-enters or re-lets for own benefit, tenant's obligations will be considered terminated by operation of law); *see also Vanity Fair Props. v. Billingsley*, 469 S.W.2d 453 (Tex. Civ. App.—San Antonio 1971, writ denied); *Cavalcade Oil Corp. v. Samuel*, 746 S.W.2d 842, 844 (Tex. App.—El Paso 1988, writ denied). A surrender by operation of law may be inferred from the facts and circumstances. *Cannon v. Freyermuth*, 4 S.W.2d 84 (Tex. Civ. App.—Dallas 1928, no writ) (where the circumstances and acts of the parties are equivalent to an agreement on the part of the tenant to

vacate the leased premises and on the part of the landlord to resume possession, a surrender results by operation of law).

Surrender by operation of law has been recognized and applied in the bankruptcy courts for the Northern District of Texas.

In Texas, surrender of a leasehold interest means that a tenant yields the leasehold estate to the landlord so that the leasehold estate comes to an end by mutual agreement of the landlord and tenant. The landlord and tenant must mutually agree to surrender the lease. The agreement may be expressed or implied. If the tenant vacates the premises and the landlord accepts possession, then an implied agreement to terminate the lease has been established.

*In re SKA! Design, Inc.*, 308 B.R. 777 (Bankr. N.D. Tex. 2004).

Several factors cause the Court to conclude that the lease has been terminated thereby obviating Nesco's claim for future rentals. First, upon review of the parties' Joint Pre-Trial Order, which was approved and entered by the Court, and which framed the issues for trial, Nesco specifically made a claim for unpaid rent; it did not assert a claim for anticipatory breach of the lease. Next, in Nesco's own chapter 11 case, upon confirmation of its chapter 11 plan, it categorically rejected all leases to which it was a party save for certain specifically listed leases (the lease with the Jays was not one of the listed leases). Ex. 68. This constituted a breach on Nesco's part under the lease and reflects, at the very least, a desire to discontinue its duties and obligations of a landlord under its existing leases. *See* 11 U.S.C. § 365(h). Third, the lease here specifically provides that Nesco may, upon the Jays' default, terminate the lease, or, in the alternative, reenter and take possession of the premises and relet to a party satisfactory to Nesco. Ex. 6. Under the latter scenario, Nesco may recover "any deficiency in the rent." *Id.* Were the lease continued here, the purchaser of the property would have presumably succeeded to Nesco's



rights. No mention is made of any claim by the purchaser. Indeed, Nesco's claim of anticipatory breach forecloses any claim by the purchaser. In short, the lease here has not been left open.

Construing the lease as terminated is also the most equitable result. The parties stipulated that the "appraised market value of the Chevron convenience store gas station after construction was \$1,100,000.00 according to an appraisal conducted by West Texas Appraisal Associates." *See Joint Pre-Trial Order.* While the Court has not been provided with an itemization of the February 10, 2006 sale of the property, it is apparent that the value received fell well short of the parties' mutual expectation of value. The Court concludes that the lease was terminated, at the latest, upon sale of the property on February 10, 2006.

(2) Non-payment of the \$240,000

The Court now turns to the question of whether to reconsider its prior ruling concerning the nonpayment by Nesco of the so-called equity in the amount of \$240,000. The Court concluded that the \$240,000 was, in effect, satisfied by increased construction costs on the project. The Jays argue that the Court must reconsider this issue given the reversal by the Fifth Circuit and the characterization of the transaction as a valid sale and lease rather than a loan. Nesco simply contends that the Court's findings and conclusions concerning the \$240,000 was not attacked on appeal and is therefore binding on the parties. The Court hereby reiterates its findings and conclusions from its September 30, 2003 and March 10 2004 Memorandum Opinions.

With respect to the facts of the case at bar, Mr. Jay testified that he sought a loan for purposes of renovating his service station and convenience store. Mr. Jay testified that he had contacted several lenders before contacting Nesco. Nesco agreed to demolish the existing facility and to construct the new one provided the .85 acre tract and the 1.04 acre tract were conveyed to Nesco. Although Mr. Jay preferred a

traditional loan, he agreed to Nesco's arrangement. There is no evidence before the court that Nesco was in the business of owning and leasing real estate. Rather, the evidence suggests that Nesco is a finance company which had its own construction crews which would build improvements that Nesco financed.

The evidence shows that the Jays had judgments entered against them; that one judgment creditor obtained a judgment lien on the 1.04 acre tract; and that, apparently, another judgment creditor obtained a judgment against both tracts of land. Nesco, as part of the transaction, paid off all such judgments. The evidence further shows that the Jays conveyed both the 1.04 acre tract and the .85 acre tract to Nesco, but that Nesco constructed improvements upon only the .85 acre tract. The value of both tracts of land together was \$306,000, of which approximately \$240,000 was equity after subtracting the judgments liens recorded against the property. Although Mr. Jay testified that, as part of his agreement with Nesco, he was to be paid the \$240,000 in equity, it is uncontested that Nesco never, in fact, paid such value. As of August 4, 2000, Nesco agreed to pay such amount provided the Jays execute a new lease and new personal guarantees. Moreover, Mr. Jay testified that part of his agreement included Nesco advancing \$150,000 for working capital and inventory. It is uncontested that Nesco advanced only \$50,000 of this money.

This evidence reveals several important considerations. First, the Jays were not *paid* for the land in question. *See Raposa v. Johnson*, 693 S.W.2d 43, 47 (Tex. App. – Fort Worth 1985, writ ref'd n.r.e.) (“deed recitals of valuable consideration, standing alone, are insufficient to prove the payment thereof”). The evidence indicates that the \$240,000 in equity, which Mr. Jay testified was to be ‘paid’ to the Jays, was included within the principal amount of the funds that the Jays were to repay in the form of rent payments. Given this scenario, the \$240,000 in equity could never have been paid, even if Nesco had sent a check to the Jays for such sum, because Nesco treated such sum as a loan to be repaid by the Jays during the life of the lease. Mr. Jay also testified that the \$150,000 was included by Nesco within the amortization schedule attached to the lease. Nesco's only witness, Mr. Erik Graham, who was Nesco's construction superintendent for the convenience store, did not refute Mr. Jay's testimony. Instead, Graham testified that Nesco's initial budget for the construction was slightly over one million dollars, and that such budget did not include costs associated with purchasing the property. Yet the amortization schedule, arrived at before any additional costs of construction could have occurred, lists the initial principal balance owing as \$1,267,898.76. This sum is significantly more than one million dollars, leading to the conclusion that some of this figure, at least, represents funds purportedly to have been advanced to the Jays for their equity.

Nesco offered no testimony explaining its failure to pay the Jays for the property. The Jays' exhibit 13, an August 14, 2000 letter from Nesco to the Jays, however, goes a long way towards explaining such failure. By such letter Nesco

requested the Jays execute a new lease, the contents of which were not admitted into evidence. The letter shows that lease payments under the new lease would have been \$17,754.00 per month, whereas the December 15, 1999, lease called for monthly payments of \$13,102.24. Nesco informed the Jays that it would not pay the \$240,000 unless the Jays executed the new lease.

The only reasonable inference to make from exhibit 13 is that Nesco considered the \$240,000 as part of the funds it was advancing the Jays, not as purchase money, but as funds that would be repaid through lease payments. Either Nesco originally agreed to 'pay' the Jays \$240,000, or it did not so agree. If it did not so agree, then the Jays were never to have been paid for the property. Moreover, if it did not so agree, but with exhibit 13 offered to subsequently advance such funds, Nesco conditioned such advance on an increase in lease payments. Given no other explanation, the court can only conclude that the increased lease payments were, at least in part, to repay Nesco for the \$240,000.

Alternatively, if Nesco did originally agree to 'pay' the Jays \$240,000, then it should have paid such regardless of costs of construction, etc. Unless, that is, the \$240,000 was to be advanced to the Jays from Nesco's budget concerning the transaction as a whole. The amortization schedule attached to the lease lists the initial principal balance owing as \$1,267,898.76. Increased construction costs may have left nothing with which to pay the \$240,000. This would explain Nesco's failure to pay the Jays, but only if Nesco considered the \$240,000 as a part of the original principal balance owing, in which case the Jays would repay such amount through lease payments. Thus, when Nesco offered to 'pay' such amount to the Jays, such amount was to be included within a new principal balance owing, which would be repaid through higher lease payments. Once again, there is no other reasonable way to construe Nesco's failure to pay the \$240,000, and subsequent conditioning of such payment upon the execution of a new lease.

If Nesco agreed to pay the Jays \$240,000 in purchase money for the properties, it should have paid such amount regardless. That it did not pay such amount, and that it instead conditioned paying such amount on an increase in monthly lease payments, demonstrates that such amount was not intended to be purchase money, but was instead intended to be a loan of funds secured by the properties.

September 30, 2003 Memorandum Opinion at 48-52.

Having held that the transaction between the Jays and Nesco is a sham transaction, and that Linc's innocent lienholder claim must fail, the court must now determine the amount of the claim held by Nesco in this bankruptcy proceeding. In its memorandum opinion, the court stated that Nesco's claim would be measured by the amount of funds actually advanced by Nesco, with an appropriate interest rate.

The lease states that the principal amount of the loan was \$1,281,000.<sup>4</sup> This sum includes the \$150,000 advance promised by Nesco. The court has found that Nesco's obligation for the \$150,000 was satisfied by the \$50,000 advance made and credits taken by the Jays for "lease" payments. The court also notes that the \$240,000 payment promised by Nesco for the Jay's equity in the property was effectively satisfied by the increased construction costs on the project.

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By the court's prior memorandum opinion, the court, consistent with its conclusion that the transaction constitute a pretended sale with the deed constituting a mortgage and further finding that the Jays had conceded that they have no homestead claim to the 1.04-acre tract, construed Nesco as holding a mortgage against the 1.04-acre tract. In making these findings, the court had overlooked its prior order entered July 31, 2003, on Nesco's motion for judgment. As set forth in such order, the Jays had conceded that the evidence presented by the Jays did not support judgment in favor of the Jays concerning the 1.04-acre tract and that Nesco, Inc. was declared to be the fee simple owner of the 1.04-acre tract. The court's prior memorandum opinion is hereby so modified.

March 10, 2004 Memorandum Opinion at 20-22.

The Court's prior findings were based on its threshold conclusion that the transaction was, in substance, a loan and a mortgage, which was clearly a function of the Court's finding that the .85-acre tract was the Jays' business homestead. Treating the transaction as a loan meant that the Jays were the owners of the property and, as such, retained whatever equity they had in the property. The Court allowed Nesco a claim for the amount actually advanced, which coincided with the "principal" amount reflected in the lease. That Nesco conditioned its payment of the \$240,000 on an increase in the loan amount and in the monthly payments was construed by the Court as additional evidence to justify its conclusion that the transaction was, in substance, a loan and mortgage. As explained above, however, the Court must now treat the transaction as a valid sale and lease and, in so doing, the evidence regarding the \$240,000 leads to a vastly different result. Nesco must have purchased the property as a condition to entering into a valid lease with

the Jays. Otherwise, the Jays lose their equity in the property. The evidence reflects that the purchase price for the two tracts was \$240,000. The evidence further reflects that this was not paid by Nesco. The undoing of the loan and mortgage theory means the Court must treat the \$240,000 as it was labeled: a payment for the Jays' equity in the two tracts. Given that it was not paid, the Jays are entitled to an offset of \$240,000.

### **Conclusion**

Nesco's claim is measured by the unpaid rentals due under the lease. The Court concludes that the lease terminated no later than February, 2006, when the property was sold. The total rent due to that date is \$680,780.17. The Jays are entitled to an offset of their equity in the property of \$240,000. Nesco's claim against Ann Jay, therefore, as of February 10, 2006, is \$440,780.17.

In liquidating Nesco's claim, the Court assumes the parties do not dispute either the amount of the rentals that accrued during the pendency of the appeals or the amount of the payment made to Linc upon sale of the property. If either of the parties disputes these facts, the Court will allow an evidentiary hearing on the disputed matters.

### End of Memorandum Opinion ###